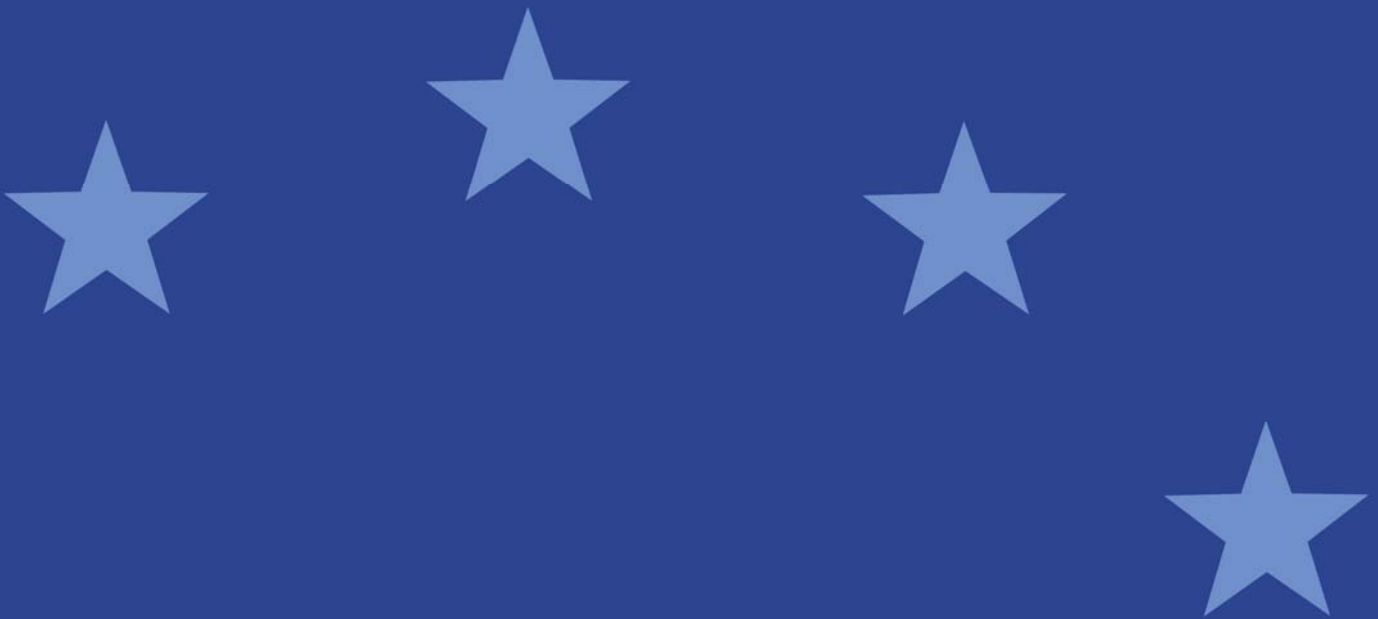




European Securities and
Markets Authority

Call for Evidence

On Pre-hedging



Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

1. respond to the question stated;
2. indicate the specific question to which the comment relates;
3. contain a clear rationale; and
4. describe any alternatives ESMA should consider.

ESMA will consider all comments received by **30 September 2022**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

Who should read this paper?

All interested stakeholders are invited to respond to this call for evidence. This call for evidence is primarily of interest to investment firms, credit institutions, proprietary traders, market makers, asset management companies and in general persons operating on an ongoing basis in financial markets, but responses are also sought from any other market participants including trade associations and industry bodies, institutional and retail investors, consultants and academics.

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References and Abbreviations

Legislative References

MAR	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC ¹
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ²
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 ³
Delegated Regulation 2017/587	Commission Delegated Regulation (EU) 2017/587 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments and on transaction execution obligations in respect of certain shares on a trading venue or by a systematic internaliser ⁴
Delegated Regulation 2017/583	Commission Delegated Regulation (EU) 2017/583 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives ⁵
Delegated Regulation 2017/565	Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational

¹ OJ L 173, 12.6.2014, p. 1.

² OJ L 173 12.6.2014, p. 349.

³ OJ L 173, 12.6.2014, p. 84.

⁴ OJ L 87, 31.3.2017, p. 387.

⁵ OJ L 87, 31.3.2017, p. 229.

requirements and operating conditions for investment firms and defined terms for the purposes of that Directive⁶

Other References

Abbreviations

CDS	Credit default swap
CFE	Call for evidence
COI	Conflict of interest
ESMA	European Securities and Markets Authority
MAR Review CP	ESMA Consultation Paper on MAR Review Report 3 October 2019 (ESMA 70-156-1459)
EU	European Union
FX	Foreign Exchange
MTF	Multilateral Trading Facility
NCA	National Competent Authority
FR	ESMA MAR Review Report of 23 September 2020 (ESMA70-156-2391)
OTC	Over the counter
OTF	Organised Trading Facility
RTS	Regulatory Technical Standards
RFQ	Request for quote
RFM	Request for market (request for a two-way quote)
SME	small and medium-sized enterprise

⁶ OJ L 87, 31.3.2017, p. 1.

Executive Summary

Reasons for publication

In the course of its MAR Review, ESMA had made market participants aware that some NCAs had received STORs on pre-hedging behaviour, a practice that is not defined in EU law. Mixed views were expressed on the usefulness of pre-hedging and the risks associated with this practice. ESMA had described that, on the one hand, pre-hedging involves a risk management aspect, as it takes place when a dealer acting as principal undertakes a trade in anticipation of a client order in order to manage the risk associated with a possible trade stemming from that order. On the other hand, pre-hedging may fall within the scope of insider trading if a broker were to use the information received from the client to make trades for his own account, including potentially trades against the client.

Several market participants asked ESMA to issue guidance on what should be considered as MAR-compliant in terms of pre-hedging and what behaviour might constitute front-running. Guidance was also requested on procedural aspects of pre-hedging, such as the documentation required, transparency regarding pre-hedging arrangements by brokers to their clients, and internal policies of market makers.

In the final report (FR) on the MAR Review, ESMA acknowledged that there are fundamentally different views on pre-hedging. As a follow-up to the MAR Review, ESMA is therefore undertaking an analysis of that practice in the market.

The purpose of this call for evidence (CFE) is to promote discussion among stakeholders in order to gather further evidence on the practice of pre-hedging that could help ESMA to develop appropriate guidance.

Contents

Section 2 of the CFE describes what pre-hedging is. EU law does not provide a specific definition of the practice of pre-hedging. That section explains the difference between hedging and pre-hedging practices, and furthermore underlines the essential difference between pre-hedging and illegal behaviour such as front running.

Section 3 provides a list of arguments critical and supportive of pre-hedging. That section provides an overview of the feedback received in the context of the MAR Review CP together with additional elements from selected research on this topic and sectoral guidance available in the market.

Section 4 analyses pre-hedging from the MAR perspective, examining whether a request for quote (RFQ) could be qualified as inside information. That section also provides guidance on a set of parameters that can be useful to evaluate the legitimacy of pre-hedging practices.

Section 5 discusses the provisions of MiFID II that firms need to comply with when engaging in pre-hedging and seeks feedback from market participants on how such provisions are currently applied. Particular focus is given to provisions governing conflicts of interest.

Next Steps

ESMA will consider the responses it receives to the CFE and then decide on the way forward.

ESMA is also aware that the European Commission has conducted a targeted consultation on the Listing Act to make public capital markets more attractive for EU companies and facilitating access to capital for SMEs⁷. ESMA therefore will monitor the outcome of that consultation and take it into account as appropriate.

⁷ [Consultation document - Targeted consultation on the listing act: making public capital markets more attractive for EU companies and facilitating access to capital for SMEs \(europa.eu\)](#).

1 Introduction

1. The practice of pre-hedging is not defined in EU law. Nevertheless, there is a general understanding among market participants of pre-hedging as a practice which takes place in financial markets, when liquidity providers aim to hedge inventory risk⁸ in an anticipatory manner. In practice, a dealer (liquidity provider) expecting to receive an order from a client⁹, may want to hedge its expected future risk arising from that order.
2. In the context of the MAR Review ESMA undertook an analysis of pre-hedging practices. The rationale for developing such analysis was that some NCAs reported concerns from market participants on pre-hedging behaviours. ESMA noted that despite pre-hedging often being motivated by a risk management rationale, the practice might raise concerns in terms of insider dealing, as a broker may be considered to have used the information received from the client about the incoming order to trade against the client.
3. In the Final Report (FR) on the MAR Review ESMA acknowledged, based on stakeholders' feedback, that there are fundamentally diverging opinions on pre-hedging. ESMA expressed the view that in order to provide guidance to market participants it is necessary to further analyse this practice to avoid adopting interpretations or recommending practices which might have unintended consequences or even provide legitimacy to harmful behaviours.
4. This CFE has the purpose of gathering additional evidence on the practice of pre-hedging.

2 Working definition of pre-hedging

5. Pre-hedging is generally understood as a form of hedging of inventory risk in an anticipatory manner in presence of a potential incoming transaction.
6. More specifically, pre hedging can be characterised as any trading activity undertaken by an investment firm, where: (i) the investment firm is dealing on its own account, and the trading activity is (ii) undertaken to mitigate an inventory risk which is foreseen due to a possible incoming transaction, (iii) undertaken before that foreseeable

⁸ Market makers set bid and ask prices for financial instruments on a continuous basis and, in doing so, they face the so-called inventory risk. This can be defined as the risk market makers are exposed to when buying or selling a security, as prices of assets on their inventories could potentially move against them.

⁹ Hereinafter, all the references to "clients" should be read as referring to counterparties as well. See Q&A5 of ESMA Q&A on market structure issues.

transaction has been executed, (iv) undertaken, at least partially, in the interest and benefit of the client or to facilitate the trade.

7. This CFE focusses on two specific trading practices which can qualify as pre-hedging: (i) a liquidity provider trading, in the context of an RFQ, ahead of the acceptance of a quote from the client and (ii) a liquidity provider trading ahead of a pending order.
8. Case (i) refers to instances where a liquidity provider¹⁰, having received an RFQ from a client but not yet its firm order, pre-hedges the position that it would have to take if it happened to win the trade, prior to the transaction finalisation.
9. Case (ii) refers to instances where a trade proposal has been submitted by the client to the liquidity provider, but the trade will be agreed and executed at a later stage, or to instances where a trade has been agreed by the client and the liquidity provider, but some elements of the trade (e.g. price) will be specified at a later stage¹¹.
10. It should be noted that market participants have expressed diverging views on whether the trading behaviours described under case (ii) should be classified as hedging or pre-hedging.
11. As hedging (as a risk reducing activity) usually takes place after the risk has been internalised by the liquidity provider, price movements triggered by the hedging activity do not have a direct price impact on the terms of the trade agreed between the liquidity provider and the client. On the contrary, the risk reducing trading activity might have a price impact on the client, for example in those instances where the price of the trade has not yet been agreed, or where the trade is agreed to be executed at a reference price to be determined in the near future, so pre-hedging might influence such prices.
12. ESMA does not intend to address the practices described under case (ii) in this CFE. Nevertheless, market participants are invited to raise any issue in this respect that they deem should be subject to further analysis.

Q1: Do you agree with the proposed working definition of pre-hedging with respect to cases (i) and (ii)? Please elaborate and provide examples on both instances.

Q2: Do you believe that the working definition of pre-hedging should encompass other market practices? Please explain.

¹⁰ Considering as such a market maker or a person dealing in its own account.

¹¹ This might encompass cases where a liquidity provider agrees with a counterparty/client to trade at a stated reference price yet to be determined or specific cases where there is an agreed understanding between the liquidity provider and a counterparty/client on a possible price improvements if they are allowed to pre-hedge.

13. Unlike traditional hedging, where the inventory risk mitigation takes place after the execution of a trade, in pre-hedging that mitigation takes place ahead of it. The table below provides an overview of the risk mitigating trades that can be considered as pre-hedging.
14. ESMA also notes that certain liquidity providers in electronic markets and/or trading OTC may avail themselves of a 'last look' functionality¹². This 'last look' permits them to accept or to reject the transaction during a time window after the client has accepted the price quoted by the liquidity provider itself.
15. In principle, the 'last look' serves legitimate purposes, namely checking the client's credit and ensuring that the offered price remains consistent with the market conditions. However, it may also enable to carry out abusive practices whereby they would benefit from pre-hedging without a firm commitment to execute the trade¹³.
16. ESMA notes that the inclusion of a pre-hedging practice in the table below does not imply an assessment of the legitimacy of such practice.

Pre-hedging: trading activity (i) dealing on own account, (ii) to mitigate an inventory risk which is foreseen due to a possible incoming transaction with a client and (iii) undertaken before the order has been confirmed by the client or a foreseeable transaction has been executed.			
Trading activity upon receipt of an RFQ, when no quote / quotes have been yet provided.	Trading activity after a quote is provided in response to the RFQ.	Trading activity after the quote has been confirmed by the party submitting the RFQ, but trading protocol allow for 'last look' from the respondent to the RFQ.	Trading activity after the agreement but before setting the conditions (e.g. price) and carrying out execution, that takes place at a later stage.

¹² When the previous trading pattern of that client has led to price movements against the firm before it could hedge, the firm may modify the quote initially offered or reject the transaction.

¹³ See principle 17 of the GFXC and GFXC's Execution principles working group report on last look available at https://www.globalfx.org/docs/gfxc_report_last_look.pdf. See as well https://files.essexcourt.com/wp-content/uploads/2018/03/08152821/Article-1_Foxton.Willan.1.pdf describing possible misuse of last look functionalities.

Q3: Do you agree with the proposed distinction between pre-hedging and hedging?

Q4: Do you have any specific concerns with respect to the practice of pre hedging being undertaken by liquidity providers when the trading protocol allows for a ‘last look’?

3 State of play and market views on the need for pre-hedging

17. Following the feedback gathered in the context of the MAR Review, ESMA has undertaken further research on the practice of pre-hedging considering sectorial guidance present in the market. This section intends to bring additional elements to that discussion, providing an overview of the arguments which are usually brought forward against and in favour of pre-hedging by market participants.

3.1 Arguments against

18. A significant number of respondents to the MAR Review CP considered that pre-hedging entails market abuse risks and that it may not be beneficial for the client or the integrity of the market (including competition distortions).

19. These respondents considered that an RFQ may meet the MAR definition of inside information partly due to the non-public nature of the RFQs. More precisely, one stakeholder noted that trading venues making use of the RFQ trading system only provide the RFQs to the liquidity providers who have been asked to respond to it. In other words, it is just the quote sent by the liquidity provider in response to the RFQ (but not the RFQ itself) what is pre-trade transparent i.e., public, under the rules of these venues.

20. Other respondents stressed that pre-hedging might have detrimental effects where the client requests quotes from two or more liquidity providers (i.e. competitive RFQs¹⁴): a liquidity provider pre-hedging when in competition with other firms might trigger a price movement which in turn affects the quotes subsequently offered to the client by other liquidity providers. This ‘first mover advantage’ effect could not only render the pre-hedging party better positioned to win the trade, but it could also impact the final price at which the trade is executed.

¹⁴ In certain markets (e.g. fixed income), obtaining quotes has traditionally been achieved by simultaneously polling multiple counterparties and comparing quotes from different parties. This is a process that has increasingly become automated, permitting the submission of competitive RFQs through electronic platforms.

21. These respondents also highlighted that the risks of insider dealing in the form of front running behaviours¹⁵ appear more pronounced when an RFQ is sent for liquid or very liquid assets, where a clear risk management rationale does not seem to exist.
22. Academic evidence suggests that dealers pre-hedging certain derivatives trades through a trade in the underlying might affect the derivative trade price to occur at a level which is more favourable to dealers and less to their clients. This might happen when a liquidity provider, who has knowledge of an upcoming derivative trade, pre-hedges prior to providing a quote to the client for the derivative transaction. In doing so, the liquidity provider is likely to impact the price of the underlying and such impact would worsen the final quote of the derivative provided to the client¹⁶.
23. The authors describe that in that situation a dealer can either protect the customer's interests by executing the hedge trade in a way that minimizes its price impact or exploit the conflict of interest by executing the hedge trade in a way that significantly impacts prices. Their conclusion is that liquidity providers tend to exploit this conflict of interest and influence prices when they have an incentive to do so¹⁷.

3.2 Arguments in favour

24. Pre-hedging is a frequent practice in financial markets that is not banned in other jurisdictions, provided that certain requirements are met: FINRA Rule 5270¹⁸ does not preclude a broker-dealer to trade for its own account to fulfil or facilitate a client's block transaction. However, when engaging in trading activity that could affect the market for the security that is the subject of the customer block order, the broker-dealer must minimize any potential disadvantage or harm in the execution of the customer's order, must not place its financial interests ahead of those of its customer, and must obtain the customer's consent to such trading activity¹⁹.
25. The Canadian Universal Market Integrity Rules²⁰ ban the practice of front-running a client order except where the principal order is submitted to hedge a position that the participant had assumed or agreed to assume before having actual knowledge of the client order, provided that the hedge is commensurate with the risk and in accordance with the ordinary practice of the participant.

¹⁵ Hereafter insider dealing in the form of front running is understood in a generic way, not only as referring to information under Article 7(1)(d) MAR.

¹⁶ Henderson, B., Pearson, N. and Wang, L., 2020. Pre-trade hedging: Evidence from the issuance of retail structured products. *Journal of Financial Economics*, 137(1)

¹⁷ See note 11.

¹⁸ <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5270>

¹⁹ See as well that ICE permits anticipatory hedging when the trader believes in good faith that the transaction will be consummated https://www.theice.com/publicdocs/futures_us/exchange_notices/Block_Trade_FAQ.pdf

²⁰ <https://www.iroc.ca/rules-and-enforcement/umir-rules/41-frontrunning>

26. Along the same line, the GFXC (Principle 11²¹ and guidance paper²²) and the FSMB standard for the execution of large trades in FICC markets²³ describe the factors under which pre-hedging would be acceptable.
27. According to the feedback received in the context of the MAR Review CP, firms (which pre-hedge their possible exposure) claim that the market risk reduction achieved translates into better quotes offered to clients, reduced volatility and lower costs for the market as a whole. For instance, certain firms customarily offer pre-hedging as an option to their clients when being requested a quote for a specific transaction. In this scenario, the firm may offer a quote in case pre-hedging is agreed and a different one in case the client does not allow to pre-hedge the transaction.
28. Some of these respondents also underlined the importance of pre-hedging for the market in certain financial instruments (such as illiquid currencies or rates) and transactions (such as bond issuances and M&A transactions), to the point of considering that the market for those financial instruments might disappear if pre-hedging of orders and transactions were further limited.

Q5: What is your view on the arguments presented in favour and against pre-hedging?

4 Pre-hedging and MAR

4.1 RFQs as inside information

1. Article 7(1)(a) of MAR identifies inside information as any information, which has not been made public, which is of a precise nature, relates, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.
2. An RFQ is a request to receive a quote submitted by a client to a liquidity provider through an RFQ system or a voice system as defined in Annex I of Delegated Regulation 2017/587 and Delegated Regulation 2017/583, as well as a request to receive a quote submitted through any other trading functionality.
3. Therefore, an RFQ corresponds to a request for an offer sent by a market participant regarding information on the transaction the market participant is interested to execute,

²¹ https://www.globalfxc.org/docs/fx_global.pdf

²² GFXC: commentary on Principle 11 and the role of pre-hedging in today's FX landscape https://www.globalfxc.org/docs/commentary_principle_11_role_prehedging.pdf

²³ https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_FINAL-05.05.21.pdf

e.g. an indication of the financial product or of the category of financial products concerned, the type of transaction sought (buy or sell), and the relevant volumes.

4. After an RFQ is sent by a market participant, the recipient liquidity provider(s) may provide quotes for the relevant financial instrument. The transaction will then be executed if the market participant submitting the RFQ accepts one of those quotes.
5. ESMA is gathering evidence on whether an RFQ can also be considered as inside information pursuant to the general definition of inside information contained in Article 7(1)(a) of MAR.

Related directly or indirectly to a financial instrument

6. ESMA understands that an RFQ regarding a specific instrument would always be directly related to the financial instrument it refers to, as it entails a potential transaction on such an instrument.

Non-public

7. RFQs submitted to trading venues making use of the RFQ trading system cannot be considered as public information at the time of receipt because only the quotes provided by the market makers will be made pre-trade transparent. At the same time, RFQs bilaterally submitted to a liquidity provider are only known by the counterparties to the foreseeable trade.
8. Moreover, with respect to the non-public nature of an RFQ, ESMA recalls that RFQs convey information about a party's intention to trade and its disclosure may adversely affect the trading interests of the person who provided that information. On that basis, an RFQ can be considered as confidential information and the corresponding contractual and MiFID obligations apply to the liquidity provider²⁴.
9. Therefore, one can conclude that RFQs can be considered as non-public information.

Precise information

10. Article 7(2) of MAR states that information is of a precise nature if it "indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred or which may reasonably be expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments

²⁴ See Articles [16\(2\)](#) of MiFID II and Article 29 of Delegated Regulation 2017/565.

or the related derivative financial instrument, the related spot commodity contracts, or the auctioned products based on the emission allowances”.

11. In this respect, ESMA is seeking evidence whether a foreseeable transaction in a specific instrument could qualify as an event specific enough to enable a conclusion to be drawn on its effect on the prices of the financial instrument concerned²⁵.
12. ESMA notes that, once an RFQ is submitted by a client, there is a reasonable expectation regarding the transaction the client is seeking to conclude.
13. In particular, preciseness seems apparent in the case of directional RFQs, where the intention to buy or sell the financial instrument is clear and the relevant effect on the price of the instrument is predictable.
14. In the case of two-way quotes (also known as request for market or RFM), where the client asks simultaneously for a quote to buy and sell, it is more difficult to infer from the client request whether after the transaction the price of the instrument may increase or decrease. On this basis, some responses to the MAR Review CP indicated that the request for a two-way quote should not be considered to be sufficiently precise to qualify as inside information.
15. In that respect, ESMA would like to recall the decision of the Court of Justice of the European Union (CJEU) in the case *Lafonta vs. Autorite des Marches Financiers*²⁶ where the CJEU concluded that a particular item of information can be deemed to be precise even if it does not make it possible to predict whether the prices of the financial instruments concerned will increase or decrease, as long as a price variation is expected²⁷.
16. ESMA would also be interested to gather evidence on whether an RFM may also be considered ‘precise’ when the receiving liquidity provider could deduce the trading intentions of the client on the basis of their past commercial relationship (e.g. if the same client customarily submits a significant ‘sell’ order on a financial instrument after having requested a two-way quote for the same instrument periodically), the market conditions or the news flow.

²⁵ Please note that this CFE only addresses the case where the foreseeable transaction in itself could impact the price of the instrument and not other cases where inside information could be embedded in the RFQ (for instance, when a liquidity provider receives an RFQ from a majority shareholder to sell his/her stake in a listed company, when such potential transaction reflects a negative forecast for the listed company).

²⁶ <https://curia.europa.eu/juris/document/document.jsf?text=&docid=162781&doclang=EN>

²⁷ In addition, ESMA notes a transaction of a significant size is able to affect the volatility of the instrument concerned. Therefore, the related RFM, despite non indicating the direction of the future trade, makes predictable a significant move of the price. As a consequence, upon the receipt of an RFM related to a transaction of a significant size, the liquidity provider may take advantage from the foreseeable volatility, e.g. by means of a straddle option.

17. In addition, ESMA would be interested to receive information in relation to other potential cases where a request for a two-way quote may also be considered as 'precise'.

Q6: In which cases could a foreseeable transaction enable a conclusion to be drawn on its effect on the prices?

Q7: Do you agree that an RFM when the liquidity provider could discover the trading intentions of the sender on the basis of their past commercial relationship, the market conditions or the news flow should be considered as precise information?

Price sensitivity

18. Article 7(4) of MAR clarifies that information is price sensitive if reasonable investors would be likely to use it as part of their investment decision. In this respect, ESMA believes that an investor would take into consideration an upcoming RFQ in its decision making where the corresponding transaction would have a significant effect on the price of the financial instrument.
19. ESMA is considering the parameters that would be necessary to determine, on a case-by-case basis, whether the price impact can be considered significant, since a number of factors may potentially influence that.
20. In this context, ESMA would like to consider whether the size of the RFQ would be one of the most relevant factors to determine the likelihood of the impact on the price of the financial instrument concerned. This seems in line with the FINRA rule on block trades²⁸ and FICC Markets Standards Board (FMSB) guidance on large trades²⁹, where specific standards³⁰ apply to the execution of large transactions.
21. ESMA also would like to gather the views of market participants on whether the size of an RFQ should be assessed in conjunction with other factors and variables present in the market at the time the RFQ is submitted, e.g. market conditions (type of trading, time of the day, volatility, etc) and the liquidity of the specific financial instrument as the other key parameters.

²⁸ Link: <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5270>

²⁹ Link: https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_FINAL-05.05.21.pdf

³⁰ The principles contained in the standards state that pre-hedging is non permissible when executing a large trade in an agency capacity. On the other hand, Principle 7 is quite restrictive by allowing pre-hedging only when the market maker acts in a principal capacity and under very limited circumstances. This includes all cases where (i) the market maker has a legitimate expectation to take on market risk and pre-hedging is undertaken at its own risk; (ii) when the trading activity is reasonable relative to the size and nature of the anticipated transaction; (iii) when pre-hedging aims at minimising the impact of the activity on the market; and (iv) when this is designed to benefit the counterparty/client.

Q8: Please provide your views regarding the criteria for the identification of RFQs that could potentially have a significant impact on the price of the relevant financial instrument. Is there any other criterion that ESMA should take into account?

4.2 Indicators of legitimate and illegitimate behaviour under MAR

22. ESMA is gathering the views of market participants regarding a non-exhaustive set of possible parameters that can be useful to evaluate the legitimacy of pre-hedging practices.
23. It is worth noting that the evaluation of the legitimacy of a practice remains to be conducted on a case-by-case basis.

4.2.1 Subjects who could legitimately pre-hedge foreseeable transactions

24. In relation to the subjects who could legitimately pre-hedge foreseeable transactions, the first example presented in the FICC Market Standards Board in its Standard for the execution of large trades³¹ can be taken as a starting point: a client asking the dealer to buy a large volume of certain fixed income instruments on its behalf at market price, where the dealer has made clear to the client that it will be acting as agent and will add a fee.
25. In this case, as the agent does not undertake any risk in respect to the transaction carried out on behalf of the client, any pre-hedging transaction undertaken by the agent does not respond to any risk management rationale, as the risk related to the transaction is borne by the client.
26. ESMA notes that this approach seems consistent with the approach followed by the Canadian authorities and in the U.S.³², that exclude the possibility of pre-hedging when acting as an agent.
27. Likewise, the codes of conduct produced by industry bodies are clear on this point. For example, the above mentioned FICC Standard for the execution of large trades

³¹ See Core principle 2: Pre-hedging is not admissible in a scenario where the dealer is acting as agent. https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_FINAL-05.05.21.pdf

³² See the Canadian UMIR – IIROC and Section 12 of CME rules for block trades: Parties to a potential block trade may engage in pre-hedging or anticipatory hedging of the position that they believe in good faith will result from the consummation of the block trade, *except for an intermediary that takes the opposite side of its own customer order.* (<https://www.cmegroup.com/content/dam/cmegroup/notices/market-regulation/2016/10/RA1613-5.pdf>). See as well, ICE Futures U.S., NASDAQ Futures Inc., CBOT, NYMEX and COMEX rules.

and the GFXC states that pre-hedging client orders is only possible when acting as a principal³³.

4.2.2 Risk management

28. The analysis of the risk management rationale of pre-hedging requires addressing three different elements: the identification of the cases where pre-hedging would be necessary, the likelihood of the execution of a transaction and the instruments used for pre-hedging.

4.2.2.1 Cases where pre-hedging would be necessary

29. ESMA would like to gather the views of market participants on whether the cases described in the GFXC Guidance on pre-hedging³⁴ adequately identify the risk management rationale that could justify such activity:

- a. Market risk exposure is reduced at the time of the transaction (i.e. risk transfer) by allowing a liquidity provider to accumulate offsetting inventory in the trading book based on the information provided by the client or potential client.
- b. Liquidity provider's hedging cost is potentially lowered by lengthening the window over which they can hedge the new exposure by permitting transactions before and after the risk transfer takes place.
- c. Liquidity providers can confirm underlying liquidity conditions by testing market liquidity in the absence of being able to validate through other sources, including systems and historical data.

30. In the absence of a sound risk management rationale, i.e. where liquidity providers do not intend to react to an RFQ or where they estimate that it is highly unlikely to be awarded with the transaction, ESMA would like to know the views of stakeholders on whether liquidity providers should abstain from pre-hedging that RFQ.

Q9: Does the GFXC Guidance describe all the possible cases of risk management rationale that could justify legitimate pre-hedging? If not, please elaborate

³³ See Principle 11: A Market Participant should only Pre-Hedge Counterparty/client orders when acting as a Principal, and should do so fairly and with transparency.

³⁴ https://www.globalfx.org/docs/commentary_principle_11_role_prehedging.pdf

Q10: Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

4.2.2.2 *Necessary link between pre-hedging and the likelihood of executing a transaction*

31. The GFXC's commentary on Principle 11 and the role of pre-hedging in today's FX landscape clarifies this link: "an *anticipated order* can be best illustrated through a voice one-way RFQ, in which a liquidity consumer requests one or more liquidity providers to provide a firm quote on a specified transaction amount. The act of requesting the quote does not mean that the liquidity consumer will accept or trade on the quote. The decision whether to trade and accept the quote lies with the liquidity consumer. However, the liquidity provider *anticipates in good faith* (that is, has reasonable expectations) that the liquidity consumer will accept the quote in which case it will become a confirmed transaction".
32. Core Principle 7 of the Standard on the execution of large trades on FICC markets also addresses this point when it indicates that pre-hedging should only be undertaken when the dealer legitimately expects to take on market risk.
33. In line with that, ESMA notes that there is no risk to pre-hedge if a transaction is not going to be concluded. An obvious example of this approach would be where a liquidity provider can only offer a quote which is far from the observable spread in the market.

Q11: Can pre-hedging be considered legitimate when the market participant is aware, on the basis of objective circumstances, that it will not be awarded the transaction?

4.2.2.3 *Financial instruments used for pre-hedging*

34. One of the responses to the MAR Review CP made a point in the context of corporate bond issuances. In those cases, where liquidity providers are hired to carry out the placing and underwriting of the issuance and know in advance that the issuance will take place, pre-hedging by means of CDS on highly diversified indices of corporate bonds should be permitted. However, pre-hedging by means of transactions in the outstanding corporate bonds of the issuer, in CDSs on the issuer and entities related to the issuer should be considered as an indicator of market abuse in the same circumstances. In this respondent's view, the use of highly diversified indices (where the influence of the bonds of the relevant issuer would be minimal) would not imply exploiting the information asymmetry that would exist between the trader and the rest of market participants.
35. Overall, ESMA understands that for most financial instruments, liquidity providers hedge their risk's exposure mainly through the use of derivatives, such as the option

market, or index futures. However, pre-hedging can also occur through additional transactions on the financial instrument object of an RFQ, or in the case of options through similar options (e.g. same underlying or same maturity).

36. ESMA requests the views of market participants on whether pre-hedging through certain financial instruments should be considered as an indicator of legitimate/illegitimate trading activity, not only in the context of corporate bond issuances but also in relation to all types of proprietary trading activity.

Q12: Can you identify financial instruments that should/should not be used for pre-hedging purposes in specific circumstances? Please elaborate

4.2.3 Interest of the client

37. ESMA is exploring whether one of the elements that can be used to differentiate front running from pre-hedging is whether the practice has been conducted for the benefit of the liquidity provider.
38. In this respect, pre-hedging could be beneficial for the client when it permits the liquidity provider to ensure the execution of the transaction and/or offer better quotes, whereas it can be detrimental to the client when it moves prices against him.
39. On this basis, ESMA notes that three cases can be identified: (1) where the liquidity provider only pursues its own interest; (2) the transaction is in the sole interest of the client and (3) the transaction is in the interest of both the client and the liquidity provider.
40. ESMA is analysing whether pre-hedging transactions under the first case may correspond to insider dealing in the form of front running. However, given the wide array of circumstances that could potentially be considered as a benefit for the client, anticipatory hedging in the third case could also constitute front running, depending on the circumstances of the case.
41. For instance, a benefit for the client would clearly exist where all or part of the financial gain made by the liquidity provider is transferred to the client or when pre-hedging would ensure the execution of the transaction for the client.
42. In line with that, ESMA requests the views of market participants on whether the client's express consent to pre-hedging could constitute a strong indicator of pre-hedging undertaken in the interest of the client. ESMA is also considering whether the client's explicit consent for the liquidity provider to pre-hedge provided on a case-by-

case basis could ground a presumption of legitimacy of the liquidity provider's behaviour³⁵.

43. On this point, ESMA notes that obtaining the client's consent for each RFQ sent may not always be feasible, especially when RFQs are sent electronically. Whereas this prior consent should be relatively simple to obtain in the case of bilateral voice negotiations, ESMA would like to gather the views of market participants on how such consent can be obtained in the case of electronic and competitive RFQs.

Q13: Please provide your views on the proposed indicators of legitimate and illegitimate pre-hedging. Would you suggest any other?

Q14: According to your experience, can express consent to pre-hedging be provided on a case-by-case basis in the context of electronic and competitive RFQs? If yes, how? Do you think the client's consent to pre-hedging should ground a presumption of legitimacy of the liquidity provider's behaviour?

Q15: Could you please indicate which are in your view the pre-hedging practices that appear to be conducted mostly in the interest of the liquidity provider and which may risk to not bring any benefit to the client?

Q16: Do you think it would be feasible for liquidity providers to provide evidence of (i) their reasonable expectation to conclude the transaction; (ii) the risk management needs behind the transactions; (iii) the benefit for the client pursued through the transaction and (iv) the client's consent? If no, please indicate potential obstacles to the provision of such evidence.

4.3 Is the liquidity of the instrument an indicator of possible illegitimate behaviour?

4.3.1 Analysis

44. Several respondents to the MAR Review CP considered that pre-hedging might be necessary for illiquid instruments³⁶ whereas it does not seem to be justified for readily available instruments.

45. Following the logic of these respondents, pre-hedging undertaken by a firm on its own account following a client's RFQ in a liquid instrument would not seem necessary. Or,

³⁵ Such presumption however could be rebutted by the NCA in case of evidence to the contrary.

³⁶ The references to liquid/illiquid instruments have to be construed in accordance with Article 6 and 13 of Commission Delegated Regulation (EU) 2017/583 for non-equity instruments and Article 11(1) of Commission Delegated Regulation (EU) 2017/587 for equity instruments.

in other words, pre-hedging in a liquid instrument might be an indicator of suspicious activity.

46. Differently, pre-hedging transactions in illiquid instruments appear to have a stronger risk-management rationale because the intervention of liquidity providers might be necessary to facilitate trading and to sustain liquidity for these instruments. Some respondents argued that, by limiting pre-hedging on certain instruments, certain markets may even disappear.
47. ESMA could not gather any clear evidence so far to consider that pre-hedging transactions in liquid instruments are an indicator of possible market abuse.
48. Moreover, the evidence gathered from other jurisdictions³⁷ does not suggest that liquidity in itself is the parameter to consider that pre-hedging for transactions in certain asset classes is intrinsically abusive.

Q17: Do you believe that the liquidity of a financial instrument should be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour? Please elaborate.

5 Pre-hedging and MiFID/ MiFIR

5.1.1 Introduction

49. In the 2019 MAR Review CP as well as the Final Report, ESMA noted that pre-hedging may create risks around managing conflicts of interest (COI) between the firm and its client. The following section discusses those MiFID II provisions that firms need to comply with when engaging in pre-hedging and seeks feedback from market participants on how such provisions are currently applied. Particular focus is given to provisions governing conflicts of interest.

³⁷ U.S. government securities are extremely liquid instruments and FINRA Rule 5270 (which foresees the cases where pre-hedging is allowed) does not apply to orders or transactions involving government securities. FINRA Rule 0150(c) lists the rules applicable to transactions in, and business activity relating to, "exempted securities," which include government securities. Rule 5270 is not included in that list of rules applicable to transactions in, and business activities relating to "exempted securities" and therefore does not apply to orders or transactions involving "exempted securities.". For additional information on the liquidity of U.S. government securities see <https://www.newyorkfed.org/medialibrary/media/research/epr/03v09n3/0309f1empdf.pdf>

50. ESMA understands that the practice of pre-hedging primarily is carried out on own account and takes place in what is described as the ‘wholesale markets’ space, where there are dealings between investment firms and eligible counterparties (ECPs)³⁸.
51. Therefore, the analysis that follows in respect of the applicability of certain provisions and the relevant obligations for firms relates to the relationships between dealers and ECPs and cannot be applied one-on-one to dealings with retail or professional counterparties/clients for which more stringent rules may apply³⁹ (such more stringent rules are not considered for the purposes of this CFE, as it focuses on counterparties/clients that are ECPs).

Q18: According to your experience does the practice of pre-hedging primarily take place in what is described as the ‘wholesale markets’ space or does this practice take place also with respect to orders / RFQs submitted by retail or professional clients?

5.1.2 Legal background - provisions governing conflicts of interest

52. MiFID II provisions regarding COIs appear relevant for the purpose of analysing the practice of pre-hedging. In the context of the organizational requirements for investment firms, Article 16(3) of MiFID II establishes that firms should take all the reasonable steps to prevent COIs which might affect the interest of the firm’s clients.
53. Article 23 of MiFID II discusses COIs in further detail, mandating investment firms to take measures in order to identify and to prevent or manage COIs which may arise between themselves and their counterparties/clients. Among other elements that firms should consider when identifying COIs, Article 33(a) of the RTS on organisational requirements and operating conditions for investment firms (Delegated Regulation (EU) 2017/565)⁴⁰ specifies as one of the cases where there would be a COI potentially detrimental for the client when the firm itself is likely to make a financial gain at the expense of the client. Additionally, Article 33(b) of Delegated Regulation 2017/565

³⁸ MiFID uses counterparty/client ‘categories’ to recognise that investors/counterparty/clients have different levels of experience, knowledge and expertise, and subsequently tailors regulatory protections provided by firms to those investors accordingly. Under this regime, investors will be retail counterparty/clients, professional counterparty/clients or eligible counterparties (ECPs). Firms must provide counterparty/clients with one of these categorisations at the start of the relationship and are expected to keep that categorisation under review. Investors will automatically be categorised upon meeting certain criteria (per se categorisation) or may ask to be treated as a more sophisticated counterparty/client (resulting in less regulatory protection but potentially enabling access to a wider range of products or services) subject to meeting further criteria set out in MiFID II (elective categorisation).

³⁹ Provisions as Best Execution (Article 27 of MiFID II), Counterparty/client Order Handling (Article 28 of MiFID II) are not applied when dealing with ECPs. Hence ESMA does not consider such provisions for the purpose of this analysis.

⁴⁰ Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

mandates firms to consider if the firm itself has an interest in the outcome of a service provided to the client, which is distinct from the client's interest in that outcome⁴¹.

54. In order to clearly identify the circumstances that constitute or might give rise to a COI and the measures to prevent or manage such conflicts, firms are expected to establish, implement and maintain a COIs policy set out in writing. Article 34 of Delegated Regulation 2017/565 specifies further details on which aspects should be included in such policies, and further clarifies that the COIs policy should be periodically reviewed and updated if needed.
55. In cases where the arrangements to prevent or manage the conflict of interest are not sufficient to prevent the risks of damage to the interests of the client, investment firms should disclose to clients the conflict of interest, as per Article 23(2) of MiFID II and Article 34(4) of Delegated Regulation 2017/565, enabling the client to make an informed decision with respect to the activity in questions.
56. Article 35 of Delegated Regulation 2017/565 further specifies that investment firms are mandated to maintain and update a record of the types of investment or ancillary service or investment activity in which a conflict of interest which might damage one or more clients has arisen or may arise.

5.1.3 Analysis

57. As described above, ESMA is considering whether pre-hedging should bring direct or indirect benefits to the clients.
58. Nonetheless, even in cases where the pre-hedging activity is undertaken to bring benefits to the client, it can still be argued that a conflict of interest between the client and the liquidity provider may arise and needs to be adequately managed.
59. As an example, the liquidity provider may pre-hedge a proportionate amount of the upcoming transaction with the aim of reducing its hedging costs. By not pre-hedging the entire size of the transaction the liquidity provider also limits the price impact of its pre-hedging activity.
60. Differently, it is possible to imagine that the liquidity provider could aim at maximising its benefits and therefore pre-hedge more than 100% of the underlying transaction.

⁴¹ Articles 33(c), (d) and (e) specify other scenarios in which conflict of interest might arise, as cases where the firm has a financial or other incentive to favour the interest of another counterparty/client or group of counterparty/clients over the interests of the counterparty/client, the firm carries on the same business as the counterparty/client or the firm will receive from a person other than the counterparty/client an inducement in relation to a service provided to the counterparty/client, in the form of monetary or non-monetary benefits or services.

61. In light of the previous consideration and taking into account the prescription regarding the establishment of a COI policy in Article 34 of Delegated Regulation 2017/565, ESMA is asking the views of market participants on whether investment firms conducting pre-hedging need to have a COI policy which should specifically address measures to be adopted to manage the conflict of interest which might arise when carrying out the practice of pre-hedging.

Q19: As an investment firm conducting pre-hedging, do you have any internal procedure addressing the COI which might arise specifically from such practice? If yes, please briefly explain the content of such procedure.

62. Additionally to the requirement of having in place a COI policy and considering that the pre-hedging activity might in some instances damage the interest of the client, ESMA is analysing whether disclosure should be undertaken.

63. More specifically, as prescribed by Article 23(2) of MiFID II, in instances where the COI policy is not sufficient to rule out the COI, firms should disclose the existence of the COI to the client as to enable it to make an informed choice. In the context of pre-hedging this translates into a requirement for the firm to inform the client that orders/RFQs might be pre-hedged and make it aware of the potential impact of such practice on the trade.

64. As to enable the client to make an informed choice, ESMA is considering the possibility of recommending investment firms to provide quotes to the client with and without pre-hedging, thereby offering the client a choice depending on his execution preferences.

Q20: According to current market practice, do investment firms disclose to clients that their RFQs might be pre-hedged? If so, does this happen on a case-by-case basis (i.e. a client is informed that a specific order might be pre-hedged) or is this rather a general disclosure? Please elaborate, distinguishing between various trading models, e.g. voice trading vs electronic trades and please specify if there are instances in which RFQ systems allow to specify if pre-hedging is conducted?

Q21: According to current market practice, are clients offered quotes with and without pre-hedging, leaving to the client a choice depending on his execution preferences? Is so in which instances?

65. In order to offer NCAs some visibility and the possibility to monitor how the practice of pre-hedging is conducted, ESMA is currently exploring whether investment firms, should keep and provide, upon request from NCAs, records of pre-hedging transactions and related trading activity, as per Article 16(6) of MiFID II and Article 35 or Delegated Regulation 2017/565.

Q22: Do you currently keep record of pre-hedging trades and related trading activity? Do you believe record keeping in this instance would be easy to implement?

66. It is also possible to envisage abusive practices in the context of pre-hedging undertaken by the requesters for quotes, whereby a large RFQ is used to obtain a benefit from the subsequent liquidity provider's pre-hedging. An example of these practices is the submission of a large RFQ after having taken a position in the financial instrument used to hedge the risk that the transaction would entail, without a genuine intention to trade.
67. Therefore, it becomes necessary to address the reciprocal obligation to provide clear and not misleading information. Since these large RFQs should typically take place between ECPs, ESMA recalls that Article 30(1) second paragraph of MiFID II establishes the obligation of Member States to ensure that, in their relationship with eligible counterparties, investment firms act honestly, fairly and professionally and communicate in a way which is fair, clear and not misleading, taking into account the nature of the eligible counterparty and of its business.
68. ESMA understands that this obligation applies reciprocally to both liquidity providers and requesters for quotes.

Q23: Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

69. Finally, ESMA notes that investment firms which, on an organised, frequent systematic and substantial basis, deal on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system are systematic internalisers⁴². These investment firms, which can be considered as liquidity providers as well, are simultaneously subject to the MiFID II and MAR obligations.
70. Systematic internalisers cannot operate any system that would "*bring together third party buying and selling interests in functionally the same way as a trading venue*"⁴³, since their trading activity is characterised by risk-facing transactions that impact the Profit and Loss account of the firm⁴⁴. Recital (19) of the Commission Delegated Regulation (EU) 2017/565 clarifies the conditions under which a systematic internaliser may engage in risk-off transactions to execute client orders and additionally ESMA

⁴² Article 4(1)(20) of the Markets in Financial Instruments Directive and Articles 12 to 17 of Commission Delegated Regulation 2017/565 on the organisational requirements of investment firms.

⁴³ Recital 19 of Commission Delegated Regulation (EU) 2017/565 on organisational requirements for investment firms.

⁴⁴ See Q&As 26 and 27 of ESMA Q&As on MiFID and MiFIR market structures topics available in <https://www.esma.europa.eu/press-news/esma-news/esma-updates-qas-mifid-ii-and-mifir-market-structures-topics>.

has provided the criteria under which a systematic internaliser would be functionally similar to a trading venue.

71. In line with that, ESMA understands that pre-hedging takes place by means of transactions that are exceptional by nature and cannot be used to circumvent the requirements stemming from MiFID II. As a consequence, ESMA considers that pre-hedging cannot be used by systematic internalisers to establish arrangements functionally similar to a trading venue, e.g. riskless back-to-back transactions under general liquidity provision agreements or contingent transactions.
72. Organised trading facilities (OTFs) are multilateral systems which are not regulated markets or MTFs and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system, where the OTF operator executes the orders on a discretionary basis⁴⁵.
73. Investment firms operating OTFs are also subject to specific limitations regarding the execution of orders against their own proprietary capital⁴⁶ and cannot connect to any systematic internaliser⁴⁷. ESMA is also of the view that the possibility to pre-hedge cannot be used to circumvent those requirements.

Q24: Should ESMA consider any other element with respect to pre-hedging and systematic internalisers and OTFs? Please elaborate.

⁴⁵ Article 4(1)(23) and 20(6) of MiFID II.

⁴⁶ Article 20(1), (2) and (3) of MiFID II.

⁴⁷ Article 20(4) of MiFID II.

6 Annexes

6.1 Annex 1

Summary of questions

Q1: Do you agree with the proposed definition of pre-hedging with respect to case (i) and (ii)? Please explain elaborating if both case (i) and case (ii) in your view can qualify as pre-hedging and providing specific examples on both instances.

Q2: Do you believe the definition should encompass other market practices? Please explain.

Q3: Do you agree with the proposed distinction between pre-hedging and hedging?

Q4: Do you have any specific concerns with respect to the practice of pre hedging being undertaken by liquidity providers when the trading protocol allows for a ‘last look’?

Q5: What is your view on the arguments presented in favour and against pre-hedging?

Q6: In which cases could a foreseeable transaction enable a conclusion to be drawn on its effect on the prices?

Q7: Do you agree that an RFM when the liquidity provider could discover the trading intentions of the sender on the basis of their past commercial relationship, the market conditions or the news flow should be considered as precise information?

Q8: Please provide your views regarding the criteria for the identification of RFQs that could potentially have a significant impact on the price of the relevant financial instrument. Is there any other criterion that ESMA should take into account?

Q9: Does the GFXC Guidance describe all the possible cases of risk management rationale that could justify legitimate pre-hedging? If not, please elaborate

Q10: Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

Q11: Can pre-hedging be considered legitimate when the market participant is aware, on the basis of objective circumstances, that it will not be awarded the transaction?

Q12: Can you identify financial instruments that should/should not be used for pre-hedging purposes? Please elaborate

Q13: Please provide your views on the proposed indicators of legitimate and illegitimate pre-hedging. Would you suggest any other?

Q14: According to your experience, can express consent to pre-hedging be provided on a case-by-case basis in the context of electronic and competitive RFQs? If yes, how? Do you think the client's consent to pre-hedging should ground a presumption of legitimacy of the liquidity provider's behaviour?

Q15: Could you please indicate which are in your view the pre-hedging practices that appear to be conducted mostly in the interest of the liquidity provider and which may risk to not bring any benefit to the client?

Q16: Do you think it would be feasible for liquidity providers to provide evidence of (i) their reasonable expectation to conclude the transaction; (ii) the risk management needs behind the transactions; (iii) the benefit for the client pursued through the transaction and (iv) the client's consent? If no, please indicate potential obstacles to the provision of such evidence.

Q17: Do you believe that the liquidity of a financial instrument should be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour? Please elaborate.

Q18: According to your experience does the practice of pre-hedging primarily take place in what is described as the 'wholesale markets' space or does this practice take place also with respect to order / RFQs submitted by retail or professional clients?

Q19: As an investment firm conducting pre-hedging, do you have any internal procedure addressing the COI which might arise specifically from such practice? If yes, please briefly explain the content of such procedure.

Q20: According to current market practice, do investment firms disclose to clients that their RFQs might be pre-hedged? If so, does this happen on a case-by-case basis (i.e. a client is informed that a specific order might be pre-hedged) or is this rather a general disclosure? Please elaborate, distinguishing between various trading models, e.g. voice trading vs electronic trades and please specify if there are instances in which RFQ systems allow to specify if pre-hedging is conducted?

Q21: According to current market practice, are clients offered quotes with and without pre-hedging, leaving to the client a choice depending on his execution preferences? Is so in which instances?

Q22: Do you currently keep record of pre-hedging trades and related trading activity? Do you believe record keeping in this instance would be easy to implement?

Q23: Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

Q24: Should ESMA consider any other element with respect to pre-hedging and systematic internalisers and OTFs? Please elaborate